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TAX CONTROVERSY CONCERNING EMPLOYEE STOCK OPTIONS

Abstract

This paper aims to analyze the tax consequences of granting employee stock options. There is much controversy as to the sources of revenues and the date on which revenues are generated. The prevailing view is that taxable income is obtained only when shares acquired as a result of stock options are sold and becomes capital income and not employment related. This has beneficial effects for taxpayers participating in such a programme. They can avoid double taxation on their income, first, when they exercise rights under options, and second, when they sell the acquired shares.

Key words: employee stock options, incentive instrument, revenues from employment relationship, revenues from capital gains, sale of call options, sale of stocks

1. Introduction

Stock options for the purchase of stocks in an enterprise are a particular form of remunerating employees, generally employed in managerial positions. The entitled person acquires, within a stock option programme, a benefit in the form of the right to acquire a specific number of stocks in the corporation in which they are employed. This is most frequently after an elapse of a defined period of time and happens without payment or partially without payment. The price must not be lower than the nominal value of the purchased stocks (article 309, section 1 of the Commercial Companies' Code). A managerial options programme may be offered as an additional emission of stocks, subscription bonds with priority shares, convertible bonds or warrants for shares swapped.

Employee (managerial) stock options constitute derivative financial instruments for which the underlying instrument are stocks (article 2, section 1, point 2 of the Act of 29th July 2005 on Trading of Financial Instruments (Journal of Law, No 183, position 1538 with subsequent changes – hereinafter

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referred to as ATFI)). Employee (managerial) stock options are known as Call Options. The acquisition of Call Options from an employer gives the right, but not the obligation, to an employee to buy a specific number of stocks in the company at a previously determined price. The option is granted to the employee free of charge or below its market value at the time it is granted usually only after a certain period of time determined in the contract has elapsed and after fulfilling the acquisition requirements. It is then possible to exercise the underlying rights resulting from employee stock options. Moreover, due to the postponement in realization of the benefit, the option plan enables the employer to keep key employees employed. Employee stock options are usually not subject to sale.

The aim of this article is to present both the consequences of granting call stock options to employees from a tax point of view as well as the consequences of exercising the rights resulting from call options and from the sale of acquired stocks, or eventually the early sale of the options. The analysis will be made from the perspective of a company being a taxpayer of corporate income tax (CIT) and subject to unlimited tax liability in Poland (see article 3, section 1 of the Act of 15th February 1992 on Corporate Income Tax; consolidated act, Journal of Law from 2011, No 74, position 397 with subsequent changes – hereinafter referred to as ACIT), and the beneficiaries of the Call Options are individuals having place of residence both in Poland (residents) and abroad (non-residents).

From the tax point of view, it's unclear as to whether these options should be classified, being a source of revenue for employees, as employment income or capital gains (accordingly article 12, section 1 as well as article 17 section 1 of the Act of 26th July 1991 on Personal Income Tax, consolidated act, Journal of Law from 2010, No 51, position item 307 with subsequent changes – hereinafter referred to as APIT)) and when this revenue (income) is generated. At the same time one should consider the tax consequences of the subsequent sale of the stocks purchased within the employee stock option programme.

This paper will also address the international aspects of taxation of such an incentive instrument. In this paper reference was made to the Model Tax Convention OECD before the updating of 22th July 2010 constituting a model for the more than 80 agreements on the avoidance of double taxation hitherto concluded by Poland (OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital, Condensed Version 2008; – hereinafter referred to as MTC OECD). The provisions of the hitherto agreements should be interpreted on the basis of the Commentary on MTC OECD prior to updating.

2. Taxation simultaneous with granting options

If the beneficiary of the options is an individual being a resident, while simultaneously being in an employment relationship with the enterprise, which is realizing the employee stock option programme, issues to be considered would be whether granting the options causes a tax liability, and if so, to which source of revenues the benefit should be classified; employment related or capital gains.

Revenues from an employment relationship would be any kind of cash payment or the value of a service or form of renumeration to an employee remaining in a service relationship, employment relationship or co-operative employment relationship with the employer (article 12, section 1 and 4 APIT). Whether the benefit should be considered a revenue from an employment relationship depends on whether it is available exclusively to employees, or also to other non-related persons presently or previously employed with an employer (the Supreme Administrative Court (NSA) ruling from 26.03.2003, 2003, file no. III SA 2219/92). The revenue is classified as employment related only when the benefit is directly related with the work performed by a person (the Supreme Administrative Court ruling of 06.05.1994, file no. SA/Łd 465/94). In the ruling of the District Administrative Court in Wrocław of 10th February 2005, file no. I SA/Wr 1038/03 there is emphasis on the fact that it is essential whether the employment relationship is legally binding or not in relationship to the benefit.

In my opinion, obtaining the right to Call Options without any payment for the purchase of stocks, does not constitute as yet, under APIT, revenue from an employment relationship since on the day of obtaining this right, an employee does not acquire any increase in net worth. He has only the potential possibility to purchase stocks at the price previously determined or without any payment. The employee may or may not exercise this right. Most frequently an employee does not have the right to pledge, sell and waive the right to stock options obtained from the employer. This makes it difficult to determine their market value.

Revenues from capital gains are considered due for taxation, even if not factually received as are revenues from the realization of the rights resulting from securities, (referred to in article 3, point 1, letter b of the ATFI), that is other sellable property rights which arise as a result of emission, and which incorporate entitlements to purchase or take over securities or which are performed through monetary settlements (derivative instruments) – or in the case of particular stock options (article 17, section 1, point 6, letter b, point 10; article 17, section 1b of the APIT). For that it is only the realization of the rights resulting from the stock options which may result in the generation of revenues from capital gains.

However, the revenue obtained from the above title should not be considered to arise from other sources of revenues referred to in article 20, section 1 of the APIT (the District Administrative Court in Warsaw ruling from 19.03.2004, file no. III SA 2501/02). In the case of the realization of property rights, a particular regulation pertaining to the source of revenues, capital gains, is binding. However, sometimes due to the tax bodies, an employee could obtain revenues from other sources if costs would be borne by a third party (a dependent company or a parent company). In such case an employee's revenue is determined to be equivalent to the value of costs borne by an employer for the realization of the incentive programme. At the same time, the sale of purchased stocks at a later date as a result of the realization of stock options would result in the generation of revenues through capital gains, referred to in article 17, section 1, point 6 of the APIT. However, it would be possible to consider revenue which previously had been qualified as revenue from other sources or as revenue from an employment relationship to be income-generation expenses from the sale of these stocks (for example an individual interpretation of the Head of the Internal Revenue Chamber in Warsaw from 27th April 2010, IPPB2/415-37/10-4/AS). In my opinion, even when costs connected with the option programme are borne by an entity not being an employer, the benefit is still in direct relation to the existing employment relationship and, thus, considering them to be as a result of other sources of the revenue would be inappropriate.

3. Taxation simultaneous with exercising options

3.1. Residents as an option beneficiaries

In terms of benefits on the date of exercising stock options there are significant interpretational differences. However the following points for qualifying these benefits give some indication (Jamroży, Spotowska 2011, Opodatkowanie opcji pracowniczych…):

1) Revenues from an employment relationship: the difference between the present market value of stocks and the agreed price to be paid for the stocks by the entitled employee is treated as a benefit partially gratuitous and its value is added to the revenue from an employment relationship on the day of exercising these options; that is, on the day of the purchase of the stocks on preferential terms. As a result the income is taxed according to a progressive tax scale (18, 32 %), and within the year an advance on the tax is collected. However, the sale of stocks purchased as a result of the realization of stock options results in the generation of capital gains (for example interpretation of the Head of the Internal Revenue Chamber in Warsaw of 8th December 2008, IPPB2/415-1334/08-4/MK).

2) Revenues from other sources – in the situation when the acquisition costs of the stocks are finally borne by a third party not being an employer; for example a specified company being part of a capital group (for example interpretation of the Head of the Internal Revenue Chamber in Warsaw of 12th May 2009, IPPB2/415-123/09-2/AK; interpretation of the Head of the Internal Revenue Chamber in Warsaw of 10th December 2009, IPPB2/415-554/09-8/MK).
3) Revenues from capital gains: income from the sale of securities or derivative financial instruments and from the exercising of the underlying rights is taxed at a rate of 19% (article 30b, section 1 of the APIT). The income subject to taxation is the difference between the sum total revenues as a result of selling derivative financial instruments and from the exercising underlying rights and expenses related to their acquisition. In the case that the exercising rights result from employee stock options, deductible costs will not be generated. Such a position was taken by the Head of the Internal Revenue Chamber in Katowice as his individual interpretation of 14th July 2008 (IPPB2/415-719/08/HS), stating that at the moment of exercising underlying rights by purchasing stocks, the tax-payer receives an income equivalent to capital gains revenues and should declare the total of these income on his PIT-38 tax return. The tax-payer is not allowed to decrease the revenues (the values of acquired stocks) by income-generating costs if he has not borne any expenses for the acquisition of these options. However, the sum of the income is equivalent to the sum of revenues obtained free of charge from exercising these underlying rights.
4) Revenues are not generated on the day of the realization of employee stock options but only upon the sale of previously acquired stocks. This income constituting the surplus between the market value of the stocks acquired by the persons entitled on the basis of a general shareholders meeting and expenditures borne for their acquisition is not subject to taxation at the time those stocks are received; this principle applies accordingly to income constituting an excess of the market value of stocks over expenses made for their acquisition from the company having legal status, which received the stocks exclusively in order to transfer their ownership to persons entitled on the basis of the resolution of the general meeting of shareholders of the issuing company (article 24, section 11 of the PIT). This regulation covers situations where the company itself issues the stocks directly to eligible employees and situations where the company issues the stocks to another company with an indication of how to dispose of those shares for employees. For deferral of tax it is enough, therefore, that the contract under which

the entitled person receives Call Options to buy stocks in the company be approved in the form of a resolution of the general meeting of shareholders. The income is taxed according to regulations covering income from capital gains (article 30b, section 1; section 2, point 1 of the APIT). The deferral of taxation on the basis of article 24, section 11 of the APIT applies also to stocks issued by both Polish and foreign companies (for example the District Administrative Court in Warsaw in the ruling of 15th September 2009, file no. III SA/Wa570/09).

Moreover, in determining the direction of interpretation the position of the Supreme Administrative Court presented in the ruling of 27th April 2011 (file no. II FSK 1410/10) should be adopted. It states that an employee who acquires stocks in a foreign company within the incentive plan is not subject to revenues from an employment relationship, taking into account that the income subject to taxation appears only in the final stage of an incentive plan; that is at the point when the stocks are sold by an employee whereas the sources of revenue are the capital gains referred to in article 17, section 1, point 6, letter a of the APIT. According to a court ruling, the opposite argument would lead to double taxation - initially at the time when stocks are received and the second time at the time of their disposal.

It is also in line with the views expressed and, among others, by the District Administrative Court in Warsaw in the ruling of 15 September 2009 file no. III SA/Wa 570/09, that upon receipt of shares on preferential terms, the capital increase obtained by a given person, regardless of the source and reason for obtaining this capital, is only considered potential. These stocks are characterized by the fact that they generate revenues only at a future time in the form of dividends or in the case of their disposal – in the form of the difference between revenue from the sale and the costs incurred for their purchase. According to the court ruling this revenue is not generated upon receipt by an employee of stock options, or at the time of acquisition of stocks, but only when they are sold. It is then that the actual capital increase to the seller occurs. The sale of shares acquired both against payment, as well as free of charge, by the participants of the incentive programme means lower income-generating costs resulting in an increase in the tax base and higher income taxes. An advantage for a participant of the incentive programme comes in the form of free acquisition of stocks, which will be taxed only upon sale of stocks acquired in this fashion. Taxation of income for an employee at the time of the purchase of the stocks, understood as the difference between the market price and the preferential price of the acquisition of the stocks, could cause that the tax-payer would pay tax also in the situation when in an economic sense he would infer losses as the price of the sale of the stocks would be lower than the price of their acquisition (see also the ruling of the

District Administrative Court in Warsaw of 23th September 2009, file no. III SA/Wa 411/09 and of 28th October 2009, file no. III SA/Wa 628/09).

The position taken by administrative courts is undoubtedly beneficial to taxpayers. A taxpayer who devotes his revenues (income) obtained from an employment relationship for the purchasing of shares is considered to have after-tax income or in other words net income after taxation. The subsequent capital gains arising from the sale are re-taxed. But the taxpayer being a participant of the employee stock options programme avoids double taxation as he is taxed for the increase in net worth only upon the disposal of shares acquired in connection with the stock options.

3.2. Non-residents as option beneficiaries

If the beneficiary of options is registered as having his place of residence in a different country which has a tax agreement with Poland and thus avoiding double taxation, first of all one should consider whether options received by employees can be classified as income from employment on the basis of article 15 of the MTC OECD. This determination should be reached at autonomously on the basis of a bilateral agreement; that is regardless of the assignment of benefits to a particular source of revenue under domestic law. Article 15, section 1 of the MTC OECD addresses salaries, wages and other similar remuneration derived by a resident in respect of an employment. An open formula ("and other similar remuneration") argues for a broad interpretation of the concept of remuneration for employment. Income from employment includes not only monetary rewards but all types of benefits such as health or life insurance coverage (Commentary on Article 15 of the MTC OECD, no. 2.1).

The term "salaries, wages and other similar remuneration" may include employee stock options, being in a direct connection with the performance of work duties. It should be distinguished between income resulting from employment, even if benefits have been awarded after termination of employment (article 15 MTC OECD), and capital gains (article 13 of the MTC OECD). Within this scope, according to a statement by MTC OECD income from employment includes profits gained from exercising options, regardless of whether the incentive programme is financed by the employer himself or a third party; i.e. a parent company. However, only benefits attributed to the option itself may be taxed and not those attributed to the subsequent holding of stocks acquired upon the exercise of that option (Commentary on article 15 of the MTC OECD, no. 12-12.15). The income is usually the difference between the market price of shares and the price eventually paid for them upon exercise of options by employees. It should be noted that the income from the options is usually subject to taxation at a different time than the period for which they had been granted. Only those

benefits that are directly related to the performance of work should be qualified as income from employment. There must be a direct economic relationship between the performance of work by a non-resident and the remuneration in the form of employee stock options. It has to be analyzed whether the granting of options is in reward for past services, or rather if it is related with the future, and thus constituting an incentive for employees to achieve specific objectives in the future. In cases of doubt, it should be recognized that employee stock options are generally provided as an incentive for future performance or as an effort by companies to retain valuable employees (Commentary on article 15 of the MTC OECD, no. 12.13; OECD 2004, Cross-border Income Tax Issues …., p. 8 and the next). In terms of work performance, the amounts paid out both before and after termination of employment which may be taxed, provided they are directly connected with the work performed there. The currency and location for paying out remuneration do not have any significance (Jamroży, Major 2012, Praca cudzoziemców…., p. 78 and the next).

According to article 15, section 1, sentence 1 of the MTC OECD remuneration received by a resident for employment services shall be generally taxable only in the state of residence of the employee. However, if employment services are performed in a different state, as referred to in article 15, section 1, sentence 2 of the MTC OECD, the received remuneration may be taxed in the state or country where the work is performed. That means that Call Stock Options granted to a non-resident by a Polish enterprise may be taxed in Poland or, in other words, in the country directly connected with the granted options where work is performed. Hence Poland has the right to tax benefits received by a non-resident. However, exercising the right depends exclusively on interpretation of federal regulations. By the acceptance of the prevailing opinion that on the date of granting the options or exercising of the underlying rights on preferential terms no income subject to taxation will be generated. A non-resident being an employee does not bear any tax burden in Poland. At the same time one method for an options beneficiary to use for elimination of double taxation is the tax credit method or the exemption method depending on the solutions accepted in a bilateral agreement.

Additionally, it is worth noting that the financing of the option programme by a company not being an employer but one of the companies being part of the capital group, infers complex problems within transfer pricing. The arm's-length principle requires that transactions between related entities be undertaken at prices and on terms and conditions that would exist between independent entities. In particular the doubts focus on the application of the arm's length principle, the implementation of an appropriate transfer pricing method, especially concerning the compensation benefits as well as the choice of comparables and the other factors considered within the application of these methods(OECD 2004, Employee Stock Option…).

4. Taxation simultaneous with the sale of options

As it has already been pointed to in Chapter 3.1 employees (residents) have benefits received as revenues from capital gains taxed at a rate of 19% (article 17, section 1, point 6 letter a; article 30b, section 1 and section 2, point 1 of the APIT).

In the case of non-residents subsequent profits obtained from stocks received as a result of exercising options, in particular the sale of stocks, are subject to taxation according to regulations of article 13 of the MTC OECD (capital gains) (Commentary on article 15 of the MTC OECD, no. 12.2; Vogel K., Lehner M., *Doppelbesteuerungsabkommen*…, before articles 6-22, no. 10). As a consequence, gains derived from the transfer of stocks are generally subject to taxation only in the contracting state of which the person transferring is a resident. It is worth noting that some new agreements with countries like Norway and Finland in order to avoid double taxation, based on the contents of article 13, section 4 of the MTC OECD, include the so-called real estate clause. It provides that gains derived by a resident of a contracting state from the transfer of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other contracting state may be taxed in that other state (here: in Poland). In other agreements with Austria, Belgium, Denmark or Germany the non-precise expression „mainly" has been used (for example "…in the company the property assets of which consist of, mainly directly or indirectly of immovable property…"). In my opinion the notion „mainly" should mean the share of the value of the immovable property in the company assets at the level higher than 50% that is adopting the direction of the interpretation in accordance with the contents of article 13, section 4 of the MTC OECD (Jamroży 2011, *Sprzedaż nieruchomości*…, p. 5 and the next). At the same time, the share of the value of immovable property must be brought to the company's total assets, without taking into account debts or other obligations, even if these obligations are secured on the immovable property (Commentary on article 15 of the MTC OECD, no. 28.4; interpretation of the Head of the Internal Revenue Chamber in Warsaw of 21st December 2010, IPPB5/423-653/10-4/AJ).

In the case of a change in place of residence by an owner of stocks, bilateral agreements with, for example, Germany and Netherlands guarantee the taxation of the increase in the value of stocks in the state of the hitherto residence of the person changing their place of residence. As the right to tax the gains from the sale of the stocks (not deriving more than 50 per cent of their value from immovable property) depends on the country of residence of the seller, - a change of tax residence would result in the diversion of profits (silent reserves) away from the hitherto tax jurisdiction. One can easily understand particular provisions in

some bilateral agreements such as the one included in article 13, section 6 of the new agreement with Germany: „In the event that an individual was a resident of a Contracting State for a period of at least five years and obtained the place of residence in the other Contracting State, paragraph 5 shall not affect the right of the first state to tax this person under its domestic legislation in respect of any capital appreciation derived from shares in companies established in the first Contracting State up to the date when that person has ceased to be domiciled in that State. If the first of the mentioned States taxes a natural person being a resident there for capital appreciation at the time that person leaves this State, and the ownership of shares is then transferred and the gains from the transfer are taxed in the other State in accordance with section 5, then that other State shall accept as the basis of the evaluation of gains from the alienation the amount, which the first State adopted as the income at the time this natural person was leaving its territory." In the case of difficulties or doubts as to the interpretation or application of the bilateral agreement, there is still a mutual agreement procedure provided for in article 25 of the MTC OECD.

5. Taxation of sold stock options

It is also worth taking a look at an alternative situation when an entitled employee sells the Call Stock Options before the date of exercising the underlying rights. Non-taxation would clearly violate the basic principles of taxation, including the principles of justice and the universality of taxation. Although the granting of stock options provides only a potential opportunity of obtaining benefits in the future, tax revenues are generated at the time of the sale of the granted stock options, even if they are not actually received.

The income from the sale of call stock options is subject to taxation applicable to the source of revenues - capital gains, which is taxed at a rate of 19% (see the position of the Head of the Internal Revenue Chamber in Katowice of 26th March 2008, IBPB2/415-12/08/HS). At the same time it does not matter whether the sale of stock options relates to shares of companies listed on foreign stock exchanges.

In the case of non-residents the gains obtained from the sale of call stock options shall be taxable due to the principles of article 13, section 5 of the MTC OECD that is only in the contracting state of which he is a resident.

6. Conclusions

The current legal status is in question as to the type of revenue options granted to employees constitutes, and at what time these revenues (income) are actually generated. One suggestion is that revenues are generated only

at the time of the sale of these stocks, having been acquired as a result of exercising Call Options, or upon an earlier sale of stock options (provided the agreement concluded with an employer provides for such an alternative). This approach is extremely beneficial to employees, emphasizing employee stock options as an incentive instrument effective for tax purposes. In acquiring stock options or exercising the rights for options, an employee will not pay any income taxes. Only revenues from the sale of stocks acquired within the employee stock option plan should be classified as: capital gains, as referred to in article 17 of the APIT.

Not participating in an employee stock option plan would mean an employee would finance the acquisition of the stocks from after-tax income (from an employment relationship). One reservation to the whole process is that tax organs still often present a very different picture in terms of which revenues are generated from incentive plans simultaneously with acquiring the stocks and which constitute employment related revenues or revenues from other sources, depending on who finances such a programme.

In an international context these tax issues may intensify particularly when, under laws governing different countries or states revenues resulting from the participation in employee stock option plans are categorized differently and at various rates. As a result of these variances, conflicts surrounding the question of double taxation, tax avoidance and low-level taxation may continue.

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